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SUBJECT: INFLATION BEGINNING TO IMPACT AZERBAIJAN'S ECONOMY

REF: (A) BAKU 446 (B) BAKU 39 (C) BAKU 274

Classified By: AMBASSADOR ANNE E. DERSE PER REASONS 1.4 (B,D)

11. (C) SUMMARY: According to multiple sources, including the IMF and the Government of Azerbaijan (GOAJ), annualized inflation in the first quarter topped 16 percent. The IMF estimates that inflation in 2007 may pass 20 percent, and could quickly outstrip GOAJ efforts to raise salaries and improve the lives of regular citizens, particularly as the effect of the January price and utility tariff increases continue. Anecdotal evidence indicates that bank deposits and retail consumer sales are not growing as quickly as last year as people have less disposable income. While Azerbaijan's oil production increases and rising international oil prices have strengthened the country's external position, the rising effects of inflation on the economy and general public are beginning to hurt. The IMF has warned that while Azerbaijan's short-term outlook remains favorable, keeping inflation from increasing further represents a major challenge. END SUMMARY.

INFLATIONARY PRESSURES GROWING

12. (C) On April 14, the Chairman of the National Bank of Azerbaijan (NBA) announced that annualized inflation during the first quarter had reached 16.6 percent, the first time a GOAJ official has publicly acknowledged that inflation is above single-digits. According to the NBA Chairman Rustamov, gradual growth in spending and increasing demand boosted the consumer price index during the first quarter. The GOAJ's inflation announcement coincided with the presentation of CPI data by the USAID-funded Economic Research Center which indicated that first quarter inflation totaled 16.98 percent. Also in April, the local American Chamber of Commerce published a report that indicated prices in the first quarter of 2007 had increased 29.49 percent compared to the same period of 2006. Separately, the IMF indicated in its Article IV report on Azerbaijan that inflation in the first quarter totaled 16.4 percent, which it characterized as fueled by a significant relaxation of macroeconomic policies and substantial wage increases, as well as by the one-off effect of the large adjustment to utilities and energy prices. The IMF estimates that inflation in 2007 will increase by a total of 18 to 22 percent.

13. (C) At an April 13 Cabinet meeting, President Aliyev hailed Azerbaijan's growing economy, noting that GDP increased by 26 percent in 2005 and 35 percent in 2006. The President also recognized the growing distortions in the economy and society. Without referencing exact figures, Aliyev reportedly ordered his Cabinet to minimize inflationary pressures, which he blamed on "strong

competition" and the "existence of monopolies." Finance Minister Sharifov told the Ambassador April 14 that the GOAJ was considering a range of anti-inflationary measures to combat rising prices (Reftel A).

EFFECTS OF INFLATION ON ECONOMY

14. (C) The effects of Azerbaijan's rapid GDP growth, large government expenditures and recent government price increases continue to ripple through the economy. Growth in the non-energy sector continues to be sluggish and the agricultural sector, the second largest sector after energy, risks contracting in 2007, according to the IMF. According to the IMF, non-oil sector GDP in 2006 increased only 8.2 percent compared to an increase of 62 percent in the oil sector.

15. (C) Banking executives at the International Bank of Azerbaijan, the largest bank in Azerbaijan, and UniBank, a medium-sized private bank, told EconOff that the growth in retail banking deposits during the first quarter of 2007 is slower than last year during the same period. Both agreed that local residents have less disposable income this year as prices in stores are continuing upward. In addition, the first higher utility bills are starting to arrive at residences and local businesses following the massive increases of January (Reftel B). The local Procter and Gamble representative told EconOff that the growth in sales has also slowed during the first quarter as consumers are reducing purchases in light of higher prices. Local news reports are also detailing how the local electricity provider, AzerEnergy, has begun turning off electricity to

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delinquent customers, while at the same time AzerEnergy is not being paid for electricity usage by large state-owned enterprises.

16. (C) During Article IV consultations in February, the IMF and Minister of Finance Sharifov discussed the risks of falling into the trap of spending more money in order to pass more benefits to Azerbaijani citizens while at the same time harming the macroeconomic environment and neutralizing the government's beneficial efforts (Reftel C). Based on anecdotal evidence from the non-energy private sector, the effects from current economic policies are beginning to cost the GOAJ by neutralizing government efforts to raise salaries to compete with the rising cost of living.

17. (C) In addition, the IMF Resident Representative believes that the GOAJ will have difficulty restraining the increase in general prices due to the large amount of money flowing in the economy and the large number of infrastructure projects expected in 2007. In 2005, in anticipation of Parliamentary elections, the GOAJ ordered large importers, wholesalers and retailers to maintain stable price levels until after the elections. In early 2006, prices slowly began to increase. For the 2008 Presidential elections, however, the GOAJ may be unable to replicate this price control scenario due to the current expansionary policies. Inflationary pressures in 2008 are likely to continue as the country's economy grows and as the GOAJ's 2007 budget expenditures pass through the economy.

COMMENT

18. (C) While Azerbaijan's oil production increases and rising international oil prices have strengthened the country's external position, the growing effects of inflation on the economy and general public are beginning to hurt. The IMF has warned that while Azerbaijan's short-term outlook remains favorable, keeping inflation from increasing further represents a major challenge. It is positive that the GOAJ,

including the President and Finance Minister, appears aware of the dangers of inflation and is contemplating steps to alleviate price increase pressures. Careful economic management will be needed to balance much needed investment in social and physical infrastructure and to spur employment, with acceptable levels of inflation.

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